The Advanced Teachings of Mrs. Langerhorn: 25
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Note to the Reader … These are not the notes of our conversations that were published earlier under the title "Mitochondria Learns to Invest". These are the papers Mrs. Langerhorn left me after she passed away. They are her advanced teachings, and as such they overlap and reinforce her earlier principles. I hope you gain from them as much as I did. The earlier lessons are incorporated in the book "Stairway to Wealth" available at LuLu.com

ARCHIPELAGOS

Dear Mitochondria,
Do you remember how we used to talk about "commodity" buildings and "franchise" buildings? Commodity buildings are those ticky-tacky stucco boxes, with identical units in each stack, that rent almost solely on price. Usually, there are a lot of such buildings in the area (that's one of the tells). And most of them are often pretty run down (that's another tell).

The reason for their low condition is, obviously, the fact that the owner competes on price. The lowest priced vacancy gets the tenant. Rather than charging for all costs of ownership, the owner finds himself discounting maintenance and just renting the unit a little cheaper. In this way, the owner is, in effect, eroding his principal. The owners in the area race each other to the bottom.

In a stable market, the most common way to make money on a commodity building is to find a "don't wanter", an owner (or, more likely, their heirs) that just want out. The price becomes current market … less costs of sale … less fix up costs … less holding costs. For example, if the fixed up building coud sell <u>today</u> for $1,000,000 and you estimate that when you sell to the next owner it would take $70,000 (i.e., 7%) off the top for sales commissions, escrow costs, title insurance, etc, then we are left with $930,000. But we have to deduct $10,000 per unit for renovation ($8,000 plus $2,000 contingency), and that 10 unit building declines to $830,000. And we'd have some empty units during the renovation, and we have to allow for the origination costs on our purchase loan, so our holding costs would be, say, $55,000. We could pay $775,000 for the commodity building and break even. We would take all that financial risk, do all that work, and we'd essentially trade dollars for dollars. If we needed a little profit so we could buy some cute shoes, we'd have to buy that building for no more than $700,000.

Obviously, it is not often that you can find a person that is so allergic to their building that they'll sell it for 70 cents on the dollar. Even if they wished to list it at that discount, there will almost certainly be some "college boy" who bids it up. And then another one anxious to beat that bid. Eventually, the final sales price will almost certainly approach full market value, and your profit evaporates.

For a number of reasons, most buildings are, in fact, commodity buildings. You make money by fixing them up and selling them to a dentist. But even still, it’s tough making a living from them.

Franchise buildings, now, are much different. Franchise buildings rent for reasons other than price. I don’t want to leave the impression that monthly rent is irrelevant, although I do know a fellow in San Marino who does very well buying classic old buildings, restoring their ancient grandeur, and renting the units to carefully selected tenants for twice what anybody else in the area is getting. He’s more successful in that narrow tranche than anybody else I’ve known. But even he could not get $2,000 a month for a $750 unit. Probably. Rent still matters, it just matters less with franchise buildings.

The reason it matters less is that franchise buildings rent for reasons other than price. You know how commodity buildings tend to group together, so that anywhere you find one, you’ll find more? Well, franchise buildings are found in groups, as well.

Franchise buildings are found on economic “islands” within the “sea” of commodity buildings. Economic islands – since there are many different ones, the word archipelago comes to mind – are characterised by one or more reasons a prospective tenant “just has” to live in that specific area and will pay a premium to do so. And the area is often, not always, but often, clearly defined. <u>This</u> side of the street is on the island, <u>that</u> side is not.

You know how certain things are built into the property and can’t be economically changed? The things that can’t be easily changed are Primary Island Charactistics. Examples might be walking distance to (a) major medical facilities; (b) broad retail; (c) a major university; (d) large employers; (e) particularly excellent public schools.

Beneficial school districts are one of my favorites. That’s not to say that they always work out the best financially, it’s just that I feel good when I have buildings served by good schools. By the looks of things, I’m not the only one. An awful lot of parents, especially single parents, generally distrust the public school system. Waiting lists for private schools and even home schooling attest to that. If one has a building within a school system with an extended history of excellence, a big concern on any parent’s mind is much reduced. People will pay for that. And it seems to me that parent / tenants in good school districts seem to move less often, which is nice if you’re not in a rent control area.

Topographical features can also help establish a franchise building. Hillside units with extensive views often rent for a premium, unless parking is inadequate.

And like our San Marino investor discovered, architectural uniqueness is it’s own beneficium. Large pre-world war II units with high ceilings, fen~~i~~estration, a fireplace in the dining room and new kitchen appliances made to look like ones from the 1920’s are almost irresistable to many high-end tenants.

Those are some ideas of possible “islands” where one can seek buildings that rent for reasons other than price. Others will occur to you. But the question remains, why should an investor prefer franchise buildings? After all, they are almost certainly more costly than a commodity building two miles away, and wouldn’t the greater price offset the benefits of franchise? Well, no. Price usually reflects today’s value, while we really want something that will promise even greater value tomorrow. Commodity buildings don’t do that. Franchise buildings do.

A commodity building begins to decline just as the last coat of paint is drying. Think cheap make-up. That precise instant in time, the tacky-paint moment, presents the building at its most appealing. You still won’t be able to get higher rents than the similar buildings on each side of you, but the vacancies will probably be shorter.

A franchise building, on the other hand, can get higher rents because it offers one or more amenities competing buildings don’t have and can’t acquire. At night you look out the window and the horizon is covered with a carpet of city lights. Those lights in the distance? Tokyo. Franchise buildings earn higher rents because they deserve them.

Higher rents usually mean annual increases will be greater (in dollar terms) and, when one pays off the building (franchise buildings are meant to form part of your retirement income), the income will be higher than if you’d bought the two story stucco box across from the elementary school, the one with different colored sheets in each window.

Start looking, as you drive about, Mitochondria, for possible economic islands. It’s there that you will find your wealth.